



Business Consulting Services

The Tax Compliance Burden of Small Business – A Profile of 50 Companies

IRS Research Conference

June 2, 2004

Office of Research



IBM and Taxpayer Burden Research

- In 1998, IRS contracted with IBM to develop an improved methodology for measuring and modeling taxpayer burden
- IRS, with IBM support, is building the capacity to measure burden incrementally, studying different groups of taxpayers one at a time
 - W&I Model completed in March 2002
 - SE completed and integrated with W&I Model in January 2003
 - SB Model is currently being developed



Major Phases of IBM Burden Studies

- Each of the burden studies has four major phases:
 - **Research Design.** IBM works with the IRS and other stakeholders to identify key research goals, establish functional objectives for the burden model, and develop a research plan.
 - **Data Collection.** IBM administers a mixed-mode (telephone and mail) survey to a large sample of taxpayers. Survey responses are merged with IRS administrative data, yielding a comprehensive data file.
 - **Model Design and Development.** IBM specifies the relationships that form the underpinning of the burden model. Included in this step are the development of a tax calculator; the mapping of taxpayer characteristics to tax system complexity; and the estimation of statistical relationships.
 - **Model Implementation.** IBM develops a software tool that allows users to run “what if” simulations and generate summary reports.



Small Business Taxpayer Burden Model

- The Small Business study presents several new challenges:
 - Small businesses incur burden associated with multiple tax types
 - Small business tax compliance activities are different from those of individuals
 - Small businesses use a variety of professionals (e.g. payroll vendors, accountants)
 - Small business tax burden predominantly consists of activities other than form completion, including recordkeeping and tax planning
 - Compliance activities can differ widely across industries

- Another difficult problem is determining which activities are “foundational”
 - Foundational activities are done primarily to successfully manage the business and would be completed even in the absence of the Federal tax system
 - Incremental activities are done specifically to comply with the Federal tax system
 - For small businesses, it is difficult to decide which activities are foundational and which are incremental – many foundational activities also facilitate tax compliance



Qualitative Research

- IBM began the implementation phase of this project by conducting 50 in-depth case studies with small business taxpayers
- The case studies were designed to support three major research objectives:
 - **Guide the Questionnaire Development** – determine activities that are tax-related and burdensome, assign priorities to different topics, identify difficult topics that require probes, reveal new issues
 - **Enhance Survey and Administrative Data** – combining survey data, administrative data, and case study information will give us a robust data set
 - **Guide the Modeling Effort** – allow us to understand and model taxpayer behaviors, guide development of the equations used to estimate burden



Income Tax Recordkeeping Findings

- The majority of SB taxpayers we spoke with use a software system such as QuickBooks, Peachtree, or an industry specific package to maintain records
 - The decision to use software is driven primarily by foundational business reasons
 - Often this software has to be modified to accommodate tax information
- SB taxpayers exhibited many common recordkeeping activities including:
 - Obtaining and organizing tax related records and receipts
 - Entering tax related information into a software based accounting system
 - Using data from their recordkeeping system to produce reports needed for tax compliance
 - Checking inputs into the accounting system for accuracy and identifying and correcting errors

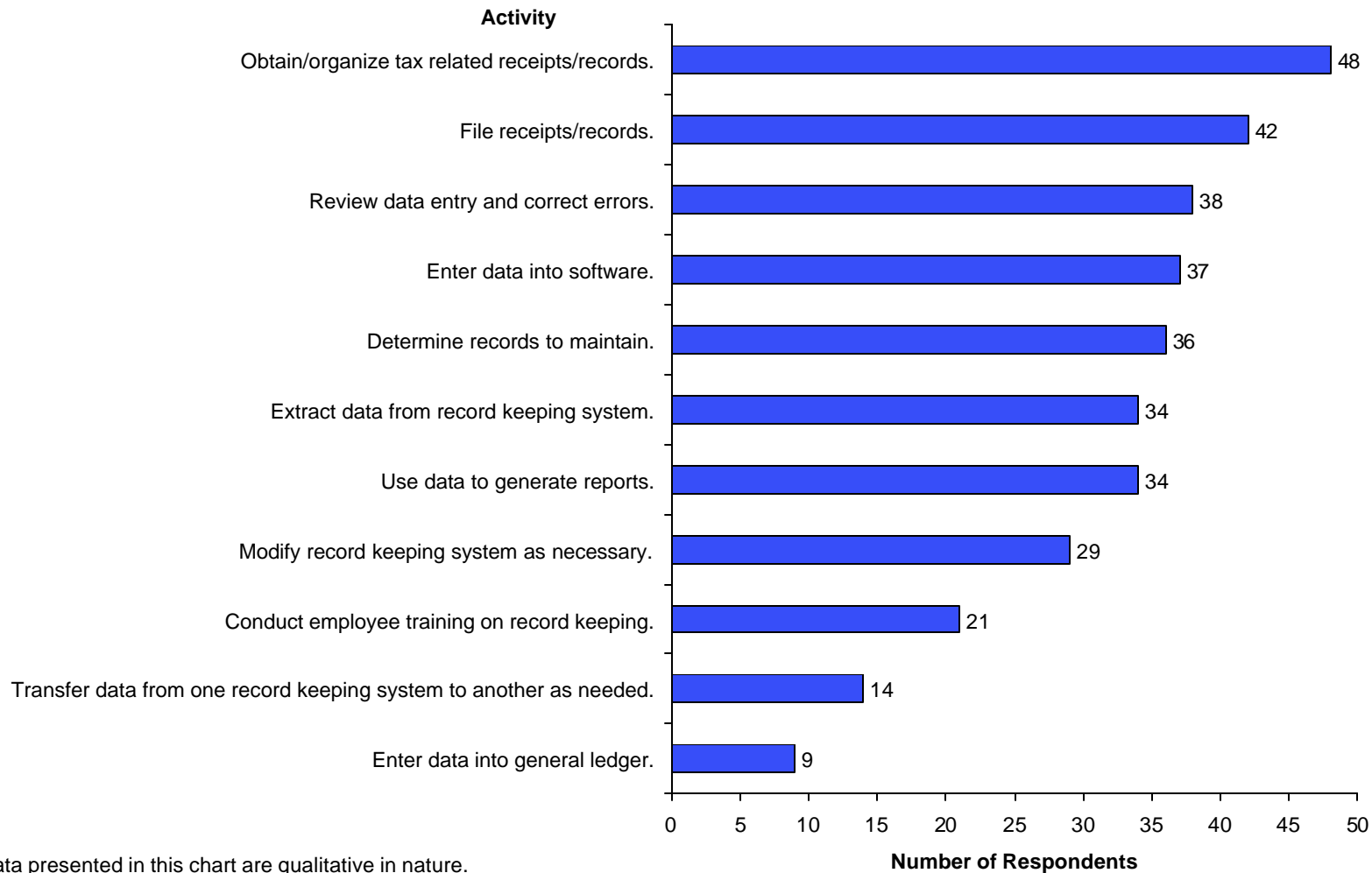


Income Tax Recordkeeping Findings

- Nearly all the SB taxpayers expended time obtaining and organizing tax related records and receipts, and entering this information into their accounting system
 - These recordkeeping activities were cited as among the most time consuming activities by a high number of taxpayers
- The types of receipts and records taxpayers mentioned frequently include:
 - Meal and entertainment expenses
 - Mileage logs
 - Receipts related to capital purchases
 - Records of charitable contributions
- The number of receipts or transactions is a key driver of recordkeeping burden



Income Tax Recordkeeping Activities,* Completed N=50



Employment Tax Recordkeeping Findings

- The most frequently mentioned recordkeeping activities were:
 - Collecting W-4 information from employees
 - Determining whether workers are employees or contractors
 - Determining the tax treatment of certain types of compensation
 - Entering information into an employment tax system and checking entries for accuracy

- Key drivers of employment tax recordkeeping burden include:
 - Number of employees
 - Use of a payroll vendor
 - Industry
 - Presence of certain types of compensation (e.g. tip income, in-kind benefits, supplemental wages, sick pay, reimbursed business expenses)

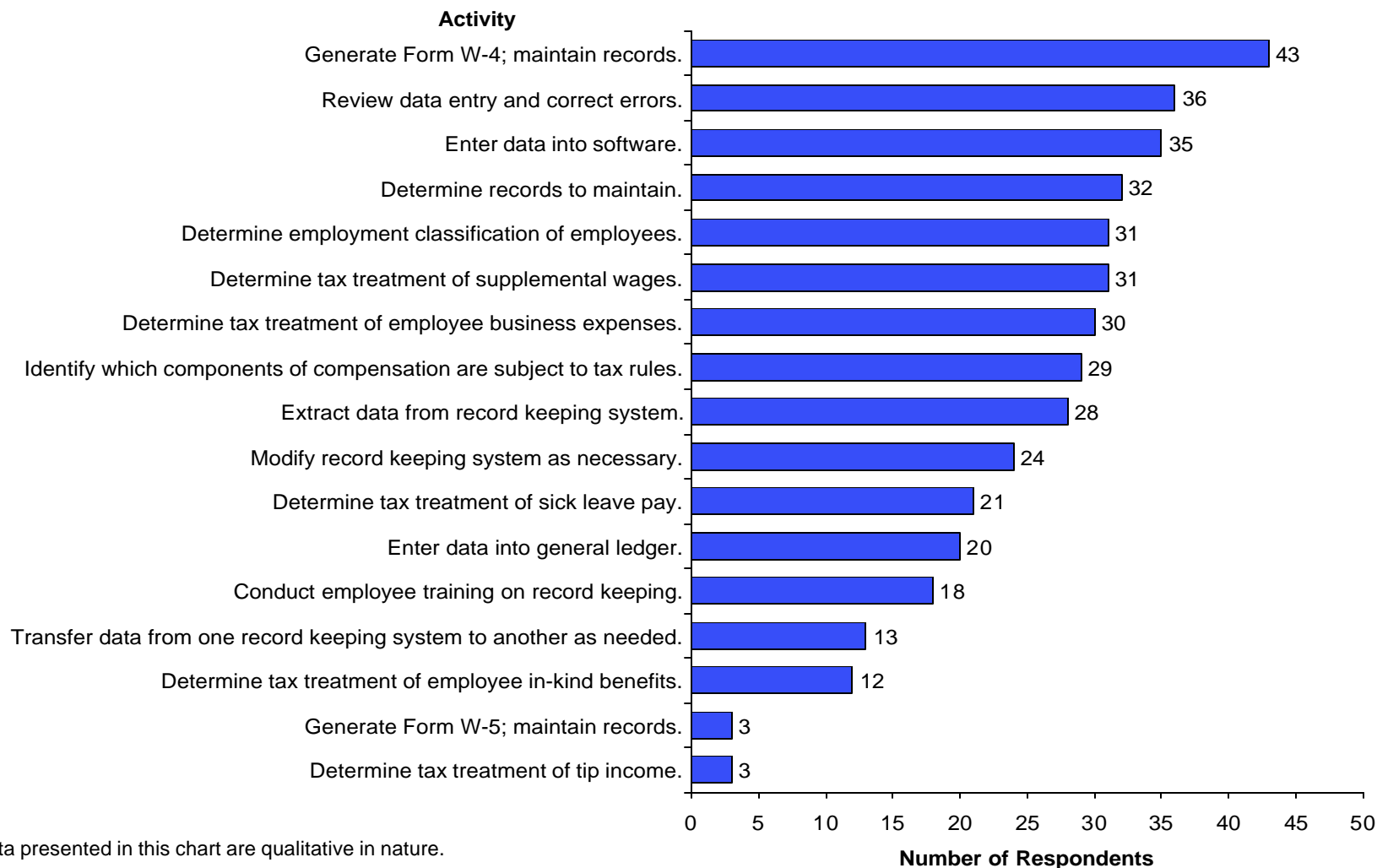


Employment Tax Recordkeeping Findings

- The majority of taxpayers we spoke with used a payroll vendor to complete both payroll and employment tax compliance activities. The key reasons for using a payroll vendor:
 - **Cost Savings** – Many of the SB taxpayers we interviewed explained that it is extremely cost effective for their business to use a payroll vendor. The amount that they pay for payroll, employment tax form preparation, tax deposits, and preparation of information returns is far less than it would cost if they decided to handle these activities in-house.
 - **Accuracy of Payroll/Employment Tax Information** – Taxpayers also explained that they use a payroll vendor to ensure the accuracy of their payroll, tax withholdings, and employment tax forms, and the timeliness and accuracy of employment tax payments. Using a payroll vendor to handle these tasks increases the accuracy of these activities and reduces the chance that the business will face scrutiny or penalties from the IRS.
 - **Privacy** – Some SB owners felt more comfortable having financial information maintained by a vendor outside the company. They believed that this information is kept more securely and accurately than it would be in-house.



Employment Tax Recordkeeping Activities,* Completed N=50



Tax Planning Findings

- Many taxpayers work with a paid professional for tax planning
 - Preparing for these meetings was cited by many as being time consuming
- The most common tax planning activities center on:
 - Business structure
 - Capital expenditures
 - Shifting income between entities or across tax years
- Most tax planning occurs near the end of the fiscal year, when businesses focus on trying to reduce taxable income
- Businesses that handle depreciation internally experience significant burden
 - Key drivers of depreciation burden include types of assets, number of assets, and industry specific depreciation methods (e.g. construction)



Tax Planning Findings

- Small business taxpayers with certain characteristics are more likely to engage in tax planning:
 - **Businesses that are profitable** – Profitable businesses engage in tax planning to reduce their taxable income
 - **SB with owners sophisticated in finance or accounting** – Owners with backgrounds in accounting or finance have a better understanding of tax planning strategies and are more likely to engage in this activity
 - **SB who use paid professionals that encourage tax planning** – Paid professionals have a major influence on the level and types of tax planning that take place



Tax Planning Activities,* Completed N=50

